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Americas Energy: GS PUMP Conference: Top ten takeaways from the PUMP Conference panels and dinners

Power, Utilities, MLPs & Pipelines Conference

(https://research.gs.com/content/research/themes/power-utilities-mlps-and-pipelines-conference-2019.html)

After hosting this year's GS Power, Utilities, Midstream & Pipeline (PUMP) Conference here in NYC on August 13th, including dinners with FE (Buy), DTE (Buy) and NEE (Buy), we reiterate our top picks, including CL-Buy utilities CNP and SRE, along with NRG within the IPP sector and LNG among midstream stocks.

GS Top Ten Takeaways from Key Panels or Dinners with Company Executives:

1. **FE expects growth to slow after 2021, but from a current elevated rate versus peers of 6%-8%,** as capital spending flattens out and equity financing needs emerge...
2. **...but FE continues to highlight the separation from FES as largely complete.** We note the Nuclear Regulatory Commission's approval of plant ownership licenses - along with bankruptcy court approvals - remain the last steps, expected by 4Q2019.

3. **Substantial regulated renewable development at DTE Electric should support a net income CAGR toward at least the high end of the 7%-8%** operating earnings growth guidance range over the next few years as both the Renewable Energy Plan (REP) and Voluntary Green Program (VGP) spend drives a substantial ramp in renewable capex to meet RPS (renewable portfolio standards) and VGP targets by 2021/2022 - along with the new natural gas power plant in 2022.
4. **Representatives from the credit ratings agencies highlighted** (1) potential does exist, but more time may be needed to prove out the business model, for IPPs to reach investment grade status; (2) changes in oil or especially natural gas production levels could weaken credit metrics for gathering/processing focused midstream companies, but this is not a major 2019 concern yet for the agencies; and (3) offshore wind construction risk emerges now as a credit concern for utility holding companies
5. **NEE views its cost position still as a primary advantage for its FP&L subsidiary** - with costs (per kWh served) at its newly acquired Gulf Power subsidiary almost 2.5x greater than the level at its larger FP&L business, implying ample room for cost management ahead.
6. **More private investment into merchant power likely will occur going forward.** Multiple PE firms highlighted that many conventional merchant generation portfolios deliver double-digit free cash yields - albeit with sizable quarterly volatility - and even after facing new challenges such as subsidized generation (nuclear) in key states like IL, OH, NJ and NY. Funds participating in our conference expect more private capital to come into the space.
7. **WTR highlighted what remains a very attractive M&A landscape for water utilities** as (1) the U.S. has ~40,000+ municipally-owned water systems, and (2) fair market value regulation allows utilities to add goodwill in municipal water utility transactions to rate base.

8. **Capital spending by regulated utilities – as discussed at the conference – will migrate more and more towards distribution** versus spend on other items including large scale transmission.
9. **The Bakken should maintain enough oil/NGL takeaway as new or potential assets come online – more long haul gas pipeline capacity** needs may emerge. In the Bakken, the expansion of the Bakken Pipeline system (DAPL/ETCOP) and startup of OKE's Elk Creek pipeline should provide producers with sufficient long-haul takeaway for both crude oil and natural gas liquids (NGLs). However, there could be additional need for Bakken long-haul natural gas takeaway in the next few years given a reduction in flaring limits and continued growth in gas production.
10. **Along with demand-pull from traditional LNG buyers (including integrated and global utilities), there is growing supply-push from Permian producers** looking to secure flow assurance and end markets for their associated gas production. These producers see new LNG facilities as a way to get their gas to market – and to also reduce flaring levels, assuming pipeline capacity exists to get the gas to the new LNG terminals.

We also highlight a few key insights from panels at the GS PUMP Conference...

Key Trends and Challenges in Midstream Infrastructure in America (Jonathan Stein, CFO, Hess Midstream Partners. Ben Atkins, CFO, NextDecade Corp.)

- NEXT's (Not Covered) Rio Grande LNG project in Brownsville, TX has key competitive advantages over other LNG sites, including proximity to the Permian Basin, and better construction economics given access to labor and an underutilized ship channel.

- A self-funding strategy with minimal leverage remains key to HESM's financing strategy. The partnership is also mitigating its counterparty risk via third-parties - which currently comprise 15% and 30% of HESM's crude oil and natural gas volumes, respectively.

CEO Fireside Chat: The Outlook for Regulated Investment and Growth (Christopher Franklin, Chairman, CEO and President, Aqua America. Charles Jones, President and CEO, FirstEnergy Corp.)

- FE highlighted key types of investment opportunities in a handful of states, including incremental grid modernization in Ohio (i.e., the deployment of ~700,000 smart meters in the state), reliability improvement in Pennsylvania, and renewables as well as energy efficiency in New Jersey (partly driven by the governor's Energy Master Plan).
- WTR noted regulatory encouragement for consolidation across water utilities, as municipalities continue to own the majority of systems in the U.S. Fair market value regulation, allowing acquirers to add goodwill related to water utility M&A in to rate base, has helped make the economics of acquisitions work for IOUs (investor-owned utility).

Merchant and Contracted Power Business Models (Francisco Martinez-Davis, CFO, Atlantica Yield. Brian Vaasjo, President and CEO, Capital Power Corp. Matthew J. O'Connor, Managing Director, Carlyle Power Partners. Darren Olagues, Executive Vice President and CFO, GenOn Energy. Himanshu Saxena, CEO, Starwood Energy Group.)

- The recent delay in the PJM auction was viewed constructively as the correct rules and processes were not in place for a two-step auction. Panelists believe that subsidized assets should not bid in to the same auction as non-subsidized assets, and this will help investors acknowledge/realize the value of competitive assets.

- California's merchant power market structure may create reliability concerns. Current market structure doesn't provide proper compensation for reliability in CA, decreasing interest in incremental baseload generation in the state. In contrast, state policy goals drive significant investment in renewable generation assets. Some panelists believe misaligned incentives and difficulty in forecasting (particularly reliability payments) could create headwinds for CA power investors, but near-term, is supporting elevated RA payments. The GenOn (Not Covered) CFO noted that the NY power market could see a similar uptick in capacity payments as large nuclear assets retire and ambitious renewable goals impact the grid.
- Merchant power (as opposed to contracted power) likely continues to expand globally, with Atlantica Yield's (AY, Not Covered) CFO noting growing levels of comfort with merchant power in other countries -- although not AY's growth strategy. Additionally, panelists highlighted foreign capital searching for yield has driven down financing costs in the U.S., but increased the need for discipline among project developers.

Renewables Ahead, The Role of Natural Gas and The Impact Across the Energy Infrastructure Industries (Peter Oleksiak, Senior Vice President and CFO, DTE Energy. Eric Silagy, President and CEO of FP&L, NextEra Energy)

- NEE highlighted that a combination of customer count and load growth help control the costs of renewables to rate payers, but replacing aging infrastructure continues to provide tailwinds as well. The company noted every $1 of O&M saved creates room for ~$7 of incremental capital spending without impacting customer bills.
- Both NEE and DTE highlighted the cost savings of fleet transformation, with NEE noting $10bn of customer savings since 2001 driven by the heat rate differential between oil and other types of generation. DTE also highlighted the LT savings driven by

fleet rationalization, such as building gas plants near distribution and storage facilities, lower fuel costs, and lower operating and maintenance expenses.

- Within DTE's generation transformation, wind remains the primary source of renewable generation, but DTE expects solar to make headway by the mid-2020s. The company noted (1) it sees significant natural demand from corporates looking to meet internal sustainability goals and (2) its desire to remain in the regulated generation business as it proceeds through fleet transformation - given the value for customers from owning vs PPA' ing a renewable asset as it depreciates.

Generation and Grid Transformation - The Path Ahead (Martin Lyons, Executive Vice President and CFO, Ameren Corporation. Antonio Smyth, Senior Vice President of Transmission, American Electric Power. Rod West, President of Utility Operations, Entergy Corporation.)

- While MO remains a relatively coal-heavy state, AEE expects wind generation capital spending to precede coal plant retirements likely to occur in the next 10-15 years driven by MO's 2035 IRP goals.

The Evolution of State Policies and The Impact on Investment and Opportunity Sets (Stephen Wemple, Director, Consolidated Edison. Maria Pope, President and CEO, Portland General Electric. Steven Rasche, Executive Vice President and CFO, Spire Inc.)

- Panelists highlighted a handful of items on their regulatory wishlists, particularly we flag (1) ED looking for more earnings opportunities from regulatory assets related to renewable projects - as the company cannot own large-scale or customer sited renewables and (2) SR (Not Covered) is looking to replicate Alabama's real-time rate making process in another states.

- POR noted the preference for onshore wind over offshore wind on the West coast continues, driven partly by geographic factors (i.e., wavier waters making the use of buoys to support turbines difficult or the relatively steep nature of the ocean floor) as well as by grid restraints due to the lack of major transmission lines along the coast.

Insights on Power, Utilities and Midstream from the Credit Ratings Agencies (Shalini Mahajan, Managing Director of US Utilities, Fitch Ratings. Peter Molica, Senior Director of US Midstream, Fitch Ratings. James Hempstead, Managing Director of US Utilities, Moody's Investors Service. Elena Nadtotchi, Senior Credit Officer on Oil & Gas, Moody's Investors Service. Michael Grande, Senior Director of Midstream Energy and Refining, S&P Global Ratings. Aneesh Prabhu, Senior Director of Midstream Energy and Refining, S&P Global Ratings.)

- Merchant power can feasibly achieve investment grade credit ratings, but the ratings agencies noted that a limited track record may require more time. The integrated model should in theory work to limit volatility and provide a counter-cyclical business strategy by pairing retail with generation, yet the lack of data around a recession provides little evidence of how it truly holds up under significant stress. Longer-term, the agencies highlighted that there is no fundamental reason why merchant power cannot become IG, given that there is a certain level of debt to EBITDA that would be acceptable and that cash flow volatility has been 17%, lower than some investment grade refiners and with higher cash flow conversion rates.
- Ratings at the holdco level continue to converge to levels around BBB+. With limited benefit to an A credit rating - given tighter spreads - the agencies noted that over the past handful of years, an increasing amount of utility holdcos moved closer to BBB+ and the cash flow to debt metrics for large holding companies declined to about 15% compared to 16% in 2018 and a 2010-2015 average of

about 20%. The agencies highlighted that as utility holdcos give themselves less of a cushion on the credit side, execution risk can become an increasingly large concern over time.

...as well as highlights from our dinners with managements

We hosted a dinner with FE on Tuesday night (8/13) with no new major takeaways, but flag...

- Incremental equity financing will occur to help fund rate base growth and pension requirements - but not likely until 2022+.
- The company views its customer rates as a competitive advantage and does not want to risk losing this edge. FE highlighted its customer bills in key states (NJ, OH, PA, etc.) remain well below peers in those states.
- FE sees limited rate case or regulatory risk - while many investors question earnings levels in OH or PA, the company highlighted that PA earnings levels remain at or below required levels - needing the state's tracker implementation to improve earnings closer to authorized levels.

...while takeaways from our dinner with DTE include...

- Substantial regulated renewable development at DTE Electric should support a net income CAGR toward at least the high end of the 7%-8% operating earnings growth guidance range over the next few years
- Management continues to bake in significant contingencies into DTE' s base case guidance. Across the subsidiaries, a level of conservatism makes the 5-7% EPS growth achievable, per management, and DTE highlighted that they often assume mild weather at the regulated segments to determine a starting guidance midpoint, emphasizing the resulting flexibility in their planning.

- Commissioner turnover has continued (with two new commissioners in MI), but DTE believes the key remains providing reliable performance and an open dialogue, understanding the commissioners' goals. Clean energy investments already continue to support significant growth, and the Utility welcomes more opportunities to transform its fleet. In general, following the 2016 energy deal, energy/utility reform does not appear top of mind for state legislators, and they feel comfortable with the current state of regulation.

...and we note a handful of highlights from our dinner with NEE

- The company believes battery storage remains in the very early stages and highlighted expectations to build batteries as part of a wind+solar+battery all-in-one development as well as building batteries in to the distribution and transmission system.
- FP&L highlighted a meaningful difference between its O&M profile relative to the recently acquired Gulf Power. The company noted non-fuel O&M of ~$12/MWh vs Gulf Power's near $30/MWh (near the national average).
- The company remains skeptical of the first wave of offshore wind, highlighting: (1) expectations for massive cost overruns leading to abandoned projects; (2) maintaining and repairing the plants will likely prove more expensive than expected; and (3) believes offshore wind in Europe has advanced largely due to saturation in European power markets.

GS Power & Utilities ratings grid

Exhibit 1: We continue to favor Diversified Utilities over pure-play Regulated Utilities
GS Power & Utilities ratings distribution

	Regulated Utilities	Diversified Utilities	IPPs
Buy	EIX, ES NI	CNP*, DTE ETR, EXC, FE NEE, SRE*	NRG*, NEP
Neutral	AEE, AEP AWK, CMS ED, PNW PPL	AGR, D PEG	CWEN
Sell	DUK, EVRG POR, SO WEC	OGE	

*Part of the Americas Conviction List

Source: Goldman Sachs Global Investment Research

GS Pipelines & MLPs ratings grid

Exhibit 2: LNG remains our top pick, followed by other large caps including ET, EPD and KMI

Pipelines and MLPs rating distribution

	C-Corps	MLPs
Buy	KMI, LNG*	ET, EPD, RTLR
Neutral	TGE, OKE, WMB, ENB, ENB.TO	CQP
Sell	TRP.TO, TRP	TCP

* Denotes Stock is on the Americas Conviction List

Source: Goldman Sachs Global Investment Research

Ratings and PT information

We reiterate our $47, 12-month target price for FE, derived using a SOTP, and remain Buy rated. Key risks for FE include utility regulation, power demand, cost management, and financing.

We remain Neutral rated AEE with a $76, 12-month price target, derived from a 19.75x P/E multiple on 2021E EPS. Key risks for AEE include regulation, project awards, and financing.

We reiterate our $88, 12-month price target for AEP, derived using a sum-of-the-parts, and remain Neutral rated. Key upside/downside risks for AEP include utility regulation, power demand, cost management, and financing.

We remain Buy rated ETR and derive our 12-month target price of $110 using a sum-of-the-parts valuation. Key risks for ETR include utility regulation, demand, and power pricing.

We reiterate our $86, 12-month price target for ED, derived from an 18x P/E multiple on 2021E EPS, and remain Neutral rated. Key risks for ED include CECONY earned RoEs, the ongoing CECONY rate case, CEB contracts, project awards, and financing.

We remain Sell rated with a $50, 12-month target price for POR, derived 85% using a fundamental 18x P/E multiple on 2021E EPS and 15% using a theoretical M&A 21.0x P/E multiple on 2021E EPS. Key risks include utility regulation and demand.

We remain Buy rated on NEE with our $221, 12-month target price, derived using an SOTP. Key risks include utility regulation, renewable development, and cost management.

We remain Buy rated on DTE with our 12 month $136 target price, derived using an SOTP. Key risks include regulatory, legislative, natural gas production, counterparty, transaction, and financing risk.

We remain Buy rated (on the CL) LNG with an $89, 12-month price target, derived with a 12x EV/EBITDA multiple on 2023E EBITDA. Key risks for LNG include construction costs, project financing, operational risk, and global natural gas prices.

We reiterate our $158, 12-month target price for SRE - derived using a sum-of-the-parts - and remain Buy rated (on the CL). Key risks for SRE include construction, utility regulation, and financing.

We remain Buy rated (on the CL) CNP with a $35, 12-month target price, derived using a sum-of-the-parts. Key risks include oil prices, merger synergies, utility regulation, and demand growth.

We remain Buy rated (on the CL) NRG with a $52, 12-month target price. We base our NRG price target 85% on a sum-of-the-parts implying $52/share and 15% on a 9.25x EV/EBITDA M&A multiple implying $54/share. Key risks include power prices, retail margins, cost management, and customer growth.

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